Retirement Plan Loans: Do You Really Want to be Your Employee’s Banker?

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• Retirement plans are not required to provide for plan loans
  ○ Optional for most plans
  ○ Generally permitted in 401(k) and 403(b) plans
  ○ Not permitted in SEPs, SIMPLE-IRAs
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• Both IRS and DOL have jurisdiction
  o IRS rules deal with taxability
  o DOL rules deal with prohibited transaction
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• Where are the rules governing plan loans found?
  - The plan document
  - The summary plan description
  - The loan procedure
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• Must participants disclose the reason for the loan?
  o Not required, but optional
  o Unlike hardship distributions in a 401(k) plan
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- What is the maximum loan available?
  - Lesser of $50,000 or 50% of vested account balance
  - Employers may set lower limits
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• What is the maximum repayment term?
  o Generally no more than 5 years
  o A reasonable period if used to acquire a principal residence
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• How must the loan be repaid?
  o Amortized ratably over the term
  o Installments must be made at least quarterly
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• What constitutes “adequate security”?
  o Most 401(k) plans use 50% of vested account balance
  o Other assets could be used instead
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• What constitutes a reasonable interest rate?
  ○ Comparable to the rate charged on a commercial loan
  ○ As a practical matter, it is generally prime plus 1% or 2%
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• What happens if there is a default in repayment?
  ○ Form 1099 issued and loan becomes taxable and could be subject to the 10% penalty for early distributions
  ○ Maximum grace period ends on the last day of quarter following the quarter of default
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- Is interest paid tax deductible?
  - If secured by employee deferrals, no
  - If made to most owners and officers, no
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**TOP TEN REASONS WHY YOU DON’T WANT TO BE YOUR EMPLOYEE’S BANKER AND ALLOW PLAN LOANS**
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#10

If there is a default, the loan becomes taxable and possibly subject to a 10% excise tax on early distributions.
If employer terminates the plan, the loan likely becomes taxable and possibly subject to a 10% excise tax on early distributions.
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#8

If the employee terminates employment, the loan likely becomes taxable and possibly subject to a 10% excise tax on early distributions.
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#7

Borrowing against retirement benefits often creates leakage (reduction of benefits) due to the inability to repay the loan.
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#6

The interest that an employee pays on a plan loan will likely be “double taxed.” Since it is not deductible, it is taxed when earned and taxed a second time when distributed from the plan.
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#5

Other loan sources available to employees (an equity line of credit) may be deductible.
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#4

Many plans suspend future deferrals until the loan is repaid.
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#3

The interest rate credited to a participant’s account is often less than they would have earned if their account was fully invested.
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#2

Employees have a smaller take home pay because of the likely payroll withholding.
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#1

Ready access to retirement benefits may facilitate impulsive spending for the wrong reason (a new boat, a vacation, etc.).
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**TOP TEN REASONS WHY YOU SHOULD BE WILLING TO BE YOUR EMPLOYEE’S BANKER AND ALLOW PLAN LOANS**
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#10

There is no income tax consequence for a plan loan that gets repaid.
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#9

There is no 10% premature distribution excise tax for a plan loan that gets repaid.
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#8

It’s a “cheap benefit” for most employers since the employees usually bear the cost.
Since most 401(k) plans allow participant loans, an employer may be perceived as taking away an employee “entitlement” if plan loans aren’t offered.
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#6

The costs of borrowing from a retirement plan are often less than from a commercial lender.
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#5

Employees may be uncomfortable attempting to qualify for hardship distributions from 401(k) plans, not wanting to disclose to their employer personal hardship situations.
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If the loans get repaid there is no “leakage” of retirement benefits (thereby maximizing retirement benefits) that may otherwise occur if the plan provides for hardship distributions or other in-service distributions.
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Employees will appreciate the ability to borrow funds without jumping through all of the hoops that a commercial lender may require.
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Without a plan loan opportunity, employers face the prospect of good employees terminating employment simply to get access to their accounts.
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Employees will feel more comfortable deferring amounts in the employer’s 401(k) plan if they have a reasonable expectation of those amounts being made available to them in a time of need.